







**Purchasing & Editorial Disclosure:** Updated: 10/11/2021 Written By: [Redacted] | Buying a home is a significant part of the American Dream. But saving enough money for a down payment is usually the biggest obstacle for first-time homebuyers. According to the National Association of Realtors, the average down payment on a home is around 11% of the purchase price. This translates to \$33,000 on a \$300,000 mortgage. Eleven percent can add up to a significant amount of money. Plus, you will usually have to pay 2-5% for closing costs. The amount you put down will help determine your monthly payments, so it's an important factor for homebuyers. One method that some people use to finance their down payments is to tap into retirement accounts, such as a 401(k). There are two ways to use a 401(k) to finance a home purchase: borrow from it and withdraw money from it. Here are the pros and cons of these two options.

If you would like to borrow from your 401(k) to fund a home purchase, then you must do it through a "401(k) loan." A 401(k) loan is a loan that lets you borrow a certain amount of money from your 401(k) at a set interest rate. As with a standard loan, the money that you borrow will have to be repaid within a certain period of time. Not all 401(k) plans allow for loans, so the first thing you should do if you are thinking about taking out a 401(k) loan is to check with your employer to see if your plan permits loans. If your plan does have a loan option, there are many advantages to borrowing from your 401(k). It can be used to finance a wide range of needs, from education to medical expenses. And unlike other types of loans, 401(k) loans are not subject to credit checks and lengthy application processes. Because you are borrowing money from your own account, there are no third-party lenders involved. This means that you can take a 401(k) loan without having to go through a bank or other financial institution. Additionally, unlike other types of loans, 401(k) loans are not subject to income tax withholding. This means that you can avoid paying taxes on the money you borrow until you repay it. Finally, 401(k) loans typically have lower interest rates than other types of loans. This is another nice benefit of 401(k) loans. Additionally, unlike other types of loans, the interest that you pay back on your loan goes to you. You will not have to spend money making interest payments to a financial institution or to another lender. However, although 401(k) loans have many advantages, there are also some disadvantages. For example, payments on the loan are not considered 401(k) contributions. So, if your employer has a 401(k) match, your employer will not match payments you make on the loan. If you take a 401(k) loan and then leave your job, you must repay the loan before you file taxes for the year in which you left your job, otherwise, it's considered a withdrawal and taxed at ordinary income tax rates. For instance, if you had a loan on your 401(k) and left your job in October, you would have until April 15 of the following year to repay the loan. Another disadvantage for some people is the limit on how much you can borrow. The IRS limits the amount of money that can be borrowed through a 401(k) loan to the lesser of 50% of your account balance, or \$50,000. If you are trying to buy a million-dollar home, then borrowing from your 401(k) will most likely not be the best option. Additionally, you probably have to repay your 401(k) loan within five years and make payments at least quarterly. Some plans will give a borrower a longer repayment window – up to 15 years – if the loan is for the purchase of a primary residence. One last disadvantage of a 401(k) loan is that it can make it more difficult to qualify for a mortgage. Taking out a 401(k) loan pushes your debt-to-income ratio higher, which is not ideal when you're trying to qualify for a mortgage. According to Brian Sullivan, public affairs manager for the Mortgage Bankers Association, "If you've taken out a 401(k) loan, you may need to provide additional documentation to prove that you're qualified to get a mortgage."

If you decide to withdraw money from your 401(k) instead of borrowing from it, there are several things you need to know. First, if you choose to withdraw money from your 401(k), you will have to pay taxes on the money you withdraw. This is because withdrawals from 401(k)s are treated as taxable income. If you are under the age of 59½, you will also have to pay a penalty of 10% on the money you withdraw. Second, unlike a 401(k) loan, the IRS does not set a limit regarding how much you are allowed to withdraw. Further, you will not be required to pay any interest on your withdrawal. This is a great benefit. Now for the disadvantages: If you are under the age of 59½, you will be charged a 10% early-withdrawal fee. So, right off the bat, you lose 10% of the money you take out. But that is not all an early withdrawal will cost you. The withdrawal is considered income, so you will pay federal and state taxes on the amount withdrawn. For example, if you withdraw \$100,000 from your 401(k) before you reach age 59½, you will pay \$10,000 in early-withdrawal fees plus taxes. If you're in the 24% tax bracket, that's another \$24,000 in federal taxes. So, \$34,000 is a steep price to pay for some quick cash. Third, if you withdraw money from your 401(k), you will have to repay it. Unlike a 401(k) loan, however, you don't have to repay it through your 401(k). Instead, you'll have to come up with the money to repay it on your own. If you don't have the money to repay it, then you should consider going with the 401(k) loan. However, if your top priority is to not have to pay back any money that you take out, then you should go with the 401(k) withdrawal. Regardless of which option you take, your 401(k) will still take a big hit, at least temporarily. Removing any money invested in a tax-deferred retirement plan will prevent you from earning the compound interest that you gain if you leave the money in your 401(k). Taking money from your 401(k) either in loan or withdrawal form is not the only way to come up with money that you can use for a down payment on a house. Here are some other options that are available: If you're a first-time homebuyer, you can get an FHA loan to finance your home purchase. With an FHA loan, you will not have to put down 10-20%. Instead, you can put a minimum of 3.5% down as long as your credit score is above 580. Gift From Friends or Family If you have a generous friend or family member who is willing to help you out with a down payment, then this is a good option. Most lenders will allow gifts to be used for a down payment. However, the amount of gift money that can be used for the down payment may vary depending on the type of loan and the lender. Be sure to ask your lender what their policies are before you try to use a gift as a down payment. One party that you are not allowed to get a gift from for a down payment is the seller. As Sullivan at HUD explains, "We (HUD) have long prohibited that the sources of payment be the seller. It is critically important that there be separation between buyer and seller in the transaction. There was a time, for a while, when the FHA would insure mortgages where the buyer of the home was contributing a down payment and the seller was contributing the rest. That practice was discontinued because it created a conflict of interest. If the seller was contributing the down payment, then the seller could pressure the buyer into buying a more expensive home than an IRA to put toward a down payment on a home. That is true as long as the amount withdrawn does not exceed \$10,000. You will still have to pay income tax on the amount withdrawn if it's a traditional IRA. There are a variety of down payment assistance programs offered by the federal government and state governments. These options are loans, second mortgages and grants. Loans and second mortgages have to be repaid, but grants do not. Whether or not you will qualify for assistance programs depends on your income and your location. If you qualify, the programs are worth the application effort. Even though there are many options available for funding a down payment on a house, one of the best methods is to simply sell assets that you already own. For example, if you own an expensive car, you can sell it and buy a cheaper car. Then, you can use the difference to pay for your down payment. The same can be done with valuable jewelry, works of art, music equipment, etc. If you can avoid borrowing money from your retirement accounts or from lenders, it could be in your best financial interest to do so. Evaluating your budget and assessing your overall financial situation can help you prepare to make a down payment without withdrawing from retirement accounts. Whether you decide to take a 401(k) loan or a withdrawal, be sure to consult with your 401(k) plan

manager to understand the details about fees, taxes and repayment time period before you make a decision.About the AuthorThe MoneyGeek editorial team has decades of combined experience in writing and publishing information about how people should manage money and credit. Our editors have worked with numerous publications including The Washington Post, The Daily Business Review, HealthDay and Time, Inc., and have won numerous journalism awards. Our talented team of contributing writers includes mortgage experts, veteran financial reporters and award-winning journalists. Learn more about the MoneyGeek team.

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